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Supreme Court, U.S.
FILED
DEC 6 2001
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No. 01-603

In The

Supreme Court of the United States

DELUXE CORPORATION,

Petitioner,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

This Court recently denied the petition for certiorari filed in *Citicorp North America, Inc. & Affiliates v. Franchise Tax Board*, 83 Cal.App.4th 1403 (2000), *cert. denied*, ___ U.S. ___, 121 S.Ct. 2623 (2001). In *Citicorp*, the California Court of Appeal held that the State may constitutionally determine the California source income of the taxable members of a unitary group by using an apportionment formula that takes into account the apportionment factors of all members of the group, including the California factors of those group members that are not themselves taxable in the State. Based upon long accepted principles of apportionment of the income of a unitary business that have been upheld repeatedly by the California Supreme Court and this Court, the Court of Appeal held in *Citicorp* that the inclusion of the income generated in California by out-of-state affiliate corporations not themselves taxable by the State in determining the portion of the unitary group's income attributable to California sources did not unconstitutionally subject the income of the affiliates to tax in the State.

Against this background, a virtually indistinguishable question is presented in this case:

> May California constitutionally determine the California source income of the taxable member of a unitary group (i.e. Deluxe) by using an apportionment formula that takes into account the apportionment factors of all the members of the group, including those out-of-state group members that are not themselves taxable in the State and whose income is not

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subject to taxation in the State pursuant to Public Law 86-272 (15 U.S.C. § 381)?

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LIST OF PARTIES

Respondent, Franchise Tax Board, accepts the List of Parties as stated by petitioner Deluxe Corporation in the Petition for Writ of Certiorari.

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RESPONDENT'S BRIEF IN OPPOSITION

Respondent Franchise Tax Board ("Board") respectfully requests that this Court deny the Petition for Writ of Certiorari ("Petition") of petitioner Deluxe Corporation (hereinafter, "Deluxe").

OPINIONS BELOW

The Board accepts Deluxe's statement of the Opinions Below as contained in its Petition and as reproduced at Appendix 1a-37a of the Petition.

STATEMENT OF JURISDICTION

The Board accepts Deluxe's statement of Jurisdiction as contained in its Petition.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Board accepts Deluxe's statement of the Constitutional and Statutory Provisions Involved as contained in its Petition and as reproduced at Appendix 38a-41a of the Petition. In addition, California Revenue and Taxation Code sections 23151, 24344, 25101, and 25120 through 25139 (in effect during the years in issue) are cited below

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and are set forth in Appendix App.1-App.14 of this brief in opposition.

STATEMENT OF THE CASE

This is an action for a refund of California franchise taxes brought by Deluxe for income years ended December 31, 1988 and December 31, 1989 ("years in issue"). Deluxe is a Minnesota corporation that primarily manufactured and sold checks to businesses throughout the United States during the years in issue.

Deluxe was engaged in a unitary business with two wholly owned subsidiaries, Current, Inc. ("Current") and Colwell Systems, Inc. ("Colwell").[1] Current was a Delaware corporation that conducted a mail order business, with all of its property and employees located at its principal place of business in Colorado. Colwell was a Delaware corporation that conducted a mail order business, with all of its property and employees located at its principal place of business in the State of Illinois. Neither Current nor Colwell were subject to California's corporation franchise or income tax during the years in issue and their activities in California did not exceed the activities

[1] A unitary business is a functionally integrated economic enterprise characterized by substantial mutual interdependence and a flow of value among members of the unitary group. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 178-179 (1983); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980), citing *Butler Brothers Stores v. McColgan*, 315 U.S. 501, 508-509 (1942).

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described in subsections (1) and (2) of 15 U.S.C. § 381(a) ["Public Law 86-272"].

A. California's Method of Taxing Corporations Engaged in a Multi-state Unitary Business Enterprise.

California imposes a franchise tax on every corporation doing business within the State. Cal. Rev. & Tax. Code § 23151. The measure of that tax is the corporation's net income derived from or attributable to sources within California. Cal. Rev. & Tax. Code § 25101. When a corporation conducts business with affiliated corporations as part of a larger unitary business enterprise operating both within and outside California, it is necessary to determine how much of the income of the unitary business is attributable to sources within California as opposed to outside the State. In these circumstances, business income derived from or attributable to California sources is determined on the basis of the unitary business formula apportionment method. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 162-163 (1983). This is a method of apportioning income in which a business conducted by related corporations as a single economic (unitary) enterprise and which earns income both in and out of California is treated as one unit for determining income attributable to sources within the State. The proportion of the business income of a unitary business attributable to California sources is determined by applying a three-factor apportionment formula, as outlined in the Uniform Division of Income for Tax Purposes Act ("UDITPA") adopted in California. Cal. Rev. & Tax. Code §§ 25120-25139.

California's three-factor apportionment formula is comprised of the average of three "factors": (1) sales factor; (2) payroll factor; and (3) property factor. Cal. Rev. & Tax. Code §§ 25129, 25132, 25134. The calculation of the numerator of the sales factor is at issue in this case. The *sales factor* is a fraction, the numerator of which is the sales of the unitary group made in California during the year, and the denominator of which is the unitary group's sales everywhere. Cal. Rev. & Tax Code § 25134.

For the years in issue, the apportionment factor was determined by adding the sales, property, and payroll factors, and dividing by three. Cal. Rev. & Tax. Code § 25128. The apportionment factor is then applied to the worldwide business income of the unitary group to determine the amount of business income attributable to California sources.

Once the business income of the unitary group is apportioned by formula to California under combined reporting principles, the tax status of each California taxpayer member of the unitary group as a separate and distinct legal entity is taken into account. The income attributable to California sources is allocated among the individual members of the unitary group that are California taxpayers in proportion to each corporation's factors in California. Each individual taxpayer's income attributable to California sources must be determined in order to arrive at its franchise tax liability. This process (intrastate apportionment) was unnecessary in this case because Deluxe is the only member of the unitary group that was subject to taxation in California. Thus, once the California source income from the unitary business was determined

by formula apportionment, it was properly allocated to Deluxe.

B. California's Method Of Computing the Factors of Its Apportionment Formula.

The dispute in this case involves the method by which California apportioned the Deluxe unitary group's sales under the State's three-factor apportionment formula during the years in issue. Under California law, sales are generally assigned for apportionment purposes to the State of their destination if the taxpayer is subject to taxation in that State. Cal. Rev. & Tax. Code § 25135. However, if the taxpayer is not taxable in the State of destination, the sales are "thrown back" to the State of origin. Thus, if a taxpayer ships property from another State to a purchaser in California, and the taxpayer is taxable in California, the sale is considered to be a sale in California and is included in the numerator of the sales factor. On the other hand, if the taxpayer is not taxable in California, the sale is "thrown back" to the State of origin and deemed to be a sale outside California – and thus excluded from the numerator of the sales factor – for apportionment factor purposes. The throwback rule arises from the fundamental premise of unitary business formula apportionment that all, but not more than all, of the income of a unitary business enterprise should be subject to taxation in the jurisdictions in which it does business.

During the years in issue, California determined that for purposes of apportionment, the term "taxpayer," as used in California Revenue and Taxation Code section

25135, referred not to the individual member of the unitary group that made the sale, but rather to the seller's unitary group as a whole. *Appeal of Finnigan Corporation*, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder, ¶ 401-797 (August 28, 1988); *Appeal of Finnigan Corporation* on rehearing, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder ¶ 402-524 (January 24, 1990). Accordingly, a sale made by a California seller to a purchaser in another State (*i.e.*, an "outbound sale") could not be thrown back to California if any other member of the seller's unitary group was taxable in the destination State, irrespective of whether the individual seller corporation was itself taxable there. Rather, that sale was treated as a sale in the State of its destination under section 25135 and excluded from California's sales factor numerator.

Conversely, a sale made by an out-of-state seller *into* California (*i.e.*, an "inbound sale") was not thrown back to the State of origin, even though the individual seller corporation was not taxable in California, if any other member of the seller's unitary group was taxable in California. *Appeal of the NutraSweet Company*, Cal. State Tax Rptr. (CCH) 1992-1993 (Pt. 2) transfer binder ¶ 402-524 (October 29, 1992).

C. California's Apportionment of the Deluxe Unitary Group's California Sales for the Years in Issue.

Current and Colwell, members of the Deluxe unitary group during the years in issue, both mailed catalogs to California residents from outside California. They both

had no physical presence in California and were not subject to California franchise tax. In addition, Current and Colwell's mail order activities in the State were limited to the activities described in subsections (1) and (2) of Public Law 86-272. Therefore, Current and Colwell themselves were not subject to taxation in California during the years in issue. Current and Colwell generated large amounts of revenue from their sales to California customers during each of the years in issue.

For the years in issue, Deluxe filed California franchise tax returns and determined its California net income by preparing a combined report that included the business income of all members of the Deluxe unitary group. Pursuant to the method of apportionment set forth in the *Appeal of Joyce, Inc.*, Cal. St. Bd. of Equal. (November 23, 1966), and FTB Legal Ruling No. 234, Deluxe took the position that the California sales of Current and Colwell should not be included in the numerator of the California sales factor used to determine the portion of the Deluxe unitary group's business income attributable to California sources, because Current and Colwell were not taxable in California.

After an audit, the Board determined that, pursuant to the method of apportionment set forth in the State Board of Equalization's *Finnigan*[2] decisions as applied in

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[2] *Appeal of Finnigan Corporation* ["*Finnigan I*"], No. 88-SBE-022, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder, ¶ 401-653 (8/25/88), and *opinion on reh'g, Appeal of Finnigan Corporation* ["*Finnigan II*"] No. 88-SBE-022-A, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder, ¶ 401-797 (1/24/90).

FTB Notice 90-3, the California-destination sales of Current and Colwell should be included in the numerator of the California sales factor used to determine the portion of the Deluxe unitary group's income attributable to California sources.[3] Pursuant to FTB Notice 90-3, the Board then assigned the California-source income of the Deluxe unitary group to the California taxpayer member of the group, Deluxe. None of the business income attributable to California sources was assigned to Current or Colwell because they are not taxable in California.

D. The Proceedings Below.

Deluxe filed suit for a tax refund in the San Francisco County Superior Court wherein it alleged that California's method of apportioning income resulted in the improper and unconstitutional taxation of the income of nontaxable members of its unitary business (Current and Colwell), in violation of Public Law 86-272 and the due process, commerce, and equal protection clauses of the United States Constitution. The trial court ruled that

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[3] Until the *Finnigan* decisions were decided by the State Board of Equalization, the Board followed the *Joyce* apportionment method. *Finnigan I* was decided on August 25, 1988, and applied to income years ending in 1977 and 1978. *Finnigan II* (Jan. 24, 1990) further clarified the State Board of Equalization's *Finnigan* holding and specifically overruled the *Joyce* rule of apportionment.

The Board is compelled to follow the State Board of Equalization's decisions on administrative appeal. Because the *Finnigan* decisions applied retroactively, the Board was compelled to apply the *Finnigan* apportionment method to the Deluxe unitary group and other similarly situated taxpayers.

California's apportionment method was constitutional and did not violate Public Law 86-272, and rendered judgment in favor of the Board. Appendix 13a-36a, 24a-25a, and 26a-32a of Petition.

Deluxe appealed. By unanimous decision, the California Court of Appeal affirmed the judgment. Appendix 1a-12a of Petition. Relying on *Citicorp North America, Inc. v. Franchise Tax Board*, 83 Cal.App.4th 1403 (2000), the Court of Appeal held:

> We hereby adopt the well-reasoned analysis of *Citicorp* and find that analysis effectively disposes of the arguments made by Deluxe on appeal. [¶] . . . The *Citicorp* court unanimously repudiated Citicorp's contention that the *Finnigan* rule of apportionment amounts to an illegal, 'indirect' tax on the income of the South Dakota affiliate. In doing so, the court relied on *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472 (*Edison*), which held 'that to compute the income allocable to one state of a unitary business operated in several states by a reasonable formula method is not to tax extraterritorial values.' (*Id.* at p. 483, citing *Butler Brothers, supra*, 315 U.S. at p. 507.) Invoking *Edison's* reasoning, *Citicorp* concluded that 'by considering the California income of Citibank (South Dakota), the FTB is not taxing but is apportioning income attributable to California. [Citation.] Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction.' (*Citicorp, supra*, 83 Cal.App.4th at p. 1415.) The court found *Edison* to be 'a clear response to Citicorp's claim that consideration of the out-of-state affiliate's California activity

> results in extraterritorial taxation.' (*Ibid.*, fn. omitted.)
>
> In so holding, *Citicorp* reaffirmed the long-established distinction between apportionment of income and the taxation of income. Recognizing this distinction, the court determined that the income of Citibank (South Dakota) was not being taxed indirectly by California, but was simply being considered in the measure of tax, i.e., in determining the amount of Citicorp's business income attributable to California sources. Appendix 7a-8a of Petition.

The Court of Appeal also relied in *Deluxe* upon *Citicorp's* reasoning in finding that the Board's application of the *Finnigan* rule did not violate the due process, commerce, and equal protection clauses of the United States Constitution. Appendix at 10a of Petition.

The California Supreme Court denied Deluxe's Petition for Review of the Court of Appeal's decision, without comment. Appendix 37a of Petition.

REASONS FOR DENYING THE PETITION

This Court should deny review of the California Court of Appeal's decision for several compelling reasons.

First, Deluxe raises issues that have no ongoing legal significance. As of April 22, 1999, California has reverted prospectively to a previously-used apportionment method in which the California sales, property and payroll of nontaxable members of a unitary business, such as Current and Colwell, are no longer attributed to

California for purposes of computing the numerators of the group's sales, property and payroll factors.

Second, although Deluxe goes to great lengths to disguise the undeniable import of the *Citicorp* decision by characterizing the question presented in this case in a different way, the issues raised herein already have been answered by *Citicorp*, a case this court declined to review. Deluxe asserts that the *Citicorp* case involved the question of whether California constitutionally could include the sales of nontaxable corporations in the sales factor of the apportionment formula while the instant case involves a purported violation of Public Law 86-272. (*See* fn. 3, p. 13 of Petition.) This is a distinction without a difference. If, as the court in *Citicorp* held, California's inclusion of the sales income of a nontaxable member of a unitary group in the apportionment formula is not taxing that income but rather is simply apportioning the unitary group's income attributable to California, then it equally is true that California's inclusion of the sales income of the nontaxable members of a unitary group, the income of which also is not subject to tax pursuant to Public Law 86-272, in the apportionment formula is not taxing that income. Because Deluxe now concedes that California is permitted under the Constitution to include the sales of nontaxable corporations in the sales factor of the apportionment formula (Petition, fn. 3) and does not dispute the amount of income apportioned to California for the years in issue (Petition, p. 13), it necessarily follows that

California's apportionment method does not result in a violation of Public Law 86-272.[4]

Third, Deluxe's arguments reflect a fundamental misapprehension of two distinct and separate concepts (a State's right to *apportion* the income of a unitary business to determine the proper state source of that income and a state's *jurisdiction* to tax individual corporations) and loses sight of the ultimate objective of the apportionment process.

I. THE ISSUE PRESENTED TO THIS COURT HAS NO ONGOING LEGAL SIGNIFICANCE.

The foremost reason why certiorari should be denied is that the issues raised in the Petition have no ongoing legal significance in California. As of April 22, 1999, California administratively changed, on a prospective basis, its method of apportioning sales to the State by returning to a previously-used apportionment method, one in which the California sales, property and payroll of nontaxable unitary members are no longer attributed to California in computing the numerators of the unitary group's sales, property and payroll factors. *See Appeal of*

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[4] At trial Deluxe argued that the California sales of the nontaxable corporations, Current and Colwell (the income of which could not be taxed pursuant to Public Law 86-272), could not be included in the numerator of the sales factor of the apportionment formula. This is the same issue presented in the *Citicorp* case. In its petition for rehearing in the Court of Appeal and its petition for review in the California Supreme Court, Deluxe conceded this issue.

Huffy Corporation, Cal. State Tax Rptr. (CCH) ¶ 403-031 (April 22, 1999).

II. THE CALIFORNIA COURT OF APPEAL'S DECISION IS FULLY CONSISTENT WITH THE *CITICORP* DECISION AND THE WELL-SETTLED DECISIONS OF THIS COURT.

Deluxe complains that California's apportionment method "threatens to render the protections afforded by Public Law 86-272 merely illusory" and that if the decision stands "all federal limitations on the states' taxing power would be at risk." (Petition, p. 18.) Deluxe misstates the significance of the California Court of Appeal's decision, especially in light of the *Citicorp* decision. In reality, what Deluxe seeks is to erode significantly many decades of decisional authority from this Court permitting a taxing State to look beyond its borders to arrive at a fair allocation to the State of a fair share of the taxable values of the taxpayer's activities within the State. *See, e.g., Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298, 311-12, n. 10 (1994); *Shell Oil Co. v. Iowa Dep't of Revenue*, 488 U.S. 19, 30-31 (1988); *Container Corp., supra*, 463 U.S. at 165; *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 219 (1980); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436 (1980); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959). *See generally International Harvester Co. v. Evatt*, 329 U.S. 416 (1947); *Butler Brothers Stores v. McColgan*, 315 U.S. 501 (1942); *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924); *Underwood Typewriter Co.*

v. Chamberlain, 254 U.S. 113 (1920). Public Law 86-272 does not affect the wisdom or application of these decisions, especially where the statute itself specifically prohibits *taxation* of a specific type of income, not consideration of that income for any and all purposes, including apportionment.

Never before in cases involving state apportionment of income has a taxpayer successfully argued before this Court that a State's inclusion of the nontaxable income of a unitary group member, generated as part of the unitary business, in the apportionable income base of a unitary group member resulted in extraterritorial taxation. None of the cases cited by Deluxe that invalidated state exactions of extraterritorial income involved the apportionment of income of a unitary business.[5]

This Court has uniformly rejected such a notion on the ground that the apportionment of income is not tantamount to the taxation of income.

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[5] For example, in this Court's recent decision in *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), the issue presented did not involve the proper apportionment of income of a unitary business doing business in California. Rather, the case involved the constitutionality of California's "interest offset deduction" (Cal. Rev. & Tax. Code § 24344), which, *after the apportionment of income to individual taxpayers*, operated to assign the interest expense deduction of a corporation as a deduction against nonbusiness income. This Court held that this assignment, as applied to out-of-state taxpayers with nonbusiness income not taxable in California, caused extraterritorial income to be taxed indirectly by the State in violation of the due process clause.

For instance, in *Shell Oil Co.*, 488 U.S. at 30-31, this Court stated:

> Shell's argument hinges on the mistaken premise that including OCS-derived income in the preapportionment tax base is tantamount to the direct taxation of OCS production. But income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the State. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's taxing jurisdiction is taxed by Iowa. As our Commerce Clause analysis of apportionment formulas has made clear, the inclusion of income in the preapportioned tax base of a state apportionment formula does not amount to extraterritorial taxation. This court has repeatedly emphasized that the function of an apportionment formula is to determine the portion of a unitary business' income that can be fairly attributed to instate activities. *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 219 (1980); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 440 (1980).

It follows implicitly from these decisions that when, as here, income apportioned to the State is increased by consideration of the income and factors (such as sales to California customers) of the nontaxable members of the group, any increase in the tax base is properly borne by the taxable corporations. The combined reporting process utilized by California reflects the values in the State of the integration and interdependence of the taxable and nontaxable members of Deluxe's unitary business. It does not matter that the income of nontaxable members of the

unitary group is not subject to taxation based upon both constitutional principles as well as a federal statute. Granting certiorari to affirm, yet again, what has long been a fundamental principle of state taxation law is unwarranted.

Deluxe contends that California's apportionment method resulted in taxation of the income of Current and Colwell that may not be taxed, not only according to constitutional principles, but pursuant to Public Law 86-272. Under similar factual circumstances, the appellate court in *Citicorp* held that this application of California's apportionment method which attributed to the State the credit card sales to California customers of a nontaxpayer member of Citicorp's unitary business, thereby increasing the tax base of Citicorp's members taxable in California, did not result in indirect extraterritorial taxation.

The principle of apportionment approved in *Citicorp*, that is, that a State may include the factors of nontaxable members of a unitary group in its apportionment formula, applies regardless of the reason the individual members are not taxable. In *Citicorp*, a member of the unitary group was not taxable because it lacked substantial nexus with the taxing State under the Commerce Clause. *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977). In this case, Current and Colwell are not taxable because of the provisions of a federal statute. The critical conclusion, present in both *Citicorp* and this case, is that California does not offend the due process or commerce clauses by including the sales and income of nontaxable unitary group members in its apportionment formula. There is no meaningful distinction between the two cases. Thus, since the application of California's apportionment method did

not result in the taxation of the income of Citibank South Dakota in the *Citicorp* case, it is equally true that California's apportionment method did not result in the taxation of the income of Current and Colwell in violation of Public Law 86-272.

This Court has stated that although constitutional limits on a State's ability to tax a unitary business exist, a State nonetheless will be allowed "wide latitude" to select a method of apportionment. *Moorman Mfg. Co.*, 437 U.S. at 274. California's three-factor apportionment formula has not only met this Court's approval against constitutional challenge made under the due process clause and the commerce clause, but has become "something of a benchmark against which other apportionment formulas are judged." *Container Corp.*, 463 U.S. at 170. When a State's apportionment method represents "a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State," no constitutional violation occurs. *Moorman Mfg. Co.*, 437 U.S. at 273. California's method of apportionment thus is fully consistent with constitutionally approved principles of apportioning income for the purposes of taxation of the members of a unitary business and also does not violate Public Law 86-272.

III. DELUXE MISAPPREHENDS THE DIFFERENCE BETWEEN APPORTIONMENT AND TAXATION.

Deluxe's argument that California's *Finnigan* apportionment method shifts the income from members of the unitary group that are immune from taxation under Public Law 86-272 to the taxable member or members of the

group in order to indirectly tax what it otherwise could not tax, is fatally flawed for several reasons, as discussed below. Deluxe's "shifting of income" argument is this: although the inclusion of Current's and Colwell's California sales in the numerator of the sales factor of the apportionment formula does not violate Public Law 86-272 or the United States Constitution, the real problem is that once the California source income is determined in Step 3 (formula apportionment), it is allocated only to the taxpayer members of the unitary group (in this case, Deluxe alone) in Step 4 (intrastate apportionment). Petition, pp. 4-6. Deluxe asserts that once the California source income is determined, that amount must be allocated not only to Deluxe but also to Current and Colwell because they are not subject to tax by California under the federal statute and the United States Constitution.

A. Deluxe's Argument That a Portion of the California Source Income Must Be Allocated Back to Current and Colwell Ignores the Fundamental Objective of Apportionment.

The ultimate objective of apportionment is to determine the portion of a unitary group's income attributable to California sources, in order to determine the tax liability of its California taxpayer members. The apportionment formula is utilized to determine how much of the income of the unitary group is attributable to sources within California as opposed to all of the other States in which the group conducts business, *for the purpose of determining the measure of tax of those corporate members of the unitary group that are subject to California tax.*

California is not interested in, nor does it calculate, the measure of tax of those corporate members of the unitary group that are not taxable in California. Where (as Deluxe concedes) California is constitutionally permitted to include the sales of nontaxable corporations such as Current and Colwell in the sales factor of the apportionment formula, the California source income thereafter is properly allocated only to the California taxpayer members of the unitary group because that is the sole objective of the entire apportionment process. Thus, Deluxe's argument that a portion of the California source income must be taken out and allocated back to Current and Colwell in the intrastate apportionment step of the process makes no sense.

B. Apportionment and Taxation are Distinct and Separate Concepts.

Deluxe's attack on California's apportionment method confuses a State's *jurisdiction* to tax with *apportionment* of income. Deluxe's contention that California's apportionment of income to Deluxe's unitary group's taxable member results in indirect taxation of exempt income solely because sales to California customers are made by nontaxable members of the unitary business, the income of which also is not subject to taxation under Public Law 86-272, is contrary to the long line of decisions of this Court approving the apportionment of income of unitary business enterprises. These decisions have consistently affirmed the fundamental unitary business principle that in apportioning the combined income of a unitary group of corporations, a State is not constitutionally barred from taking into account the income and

factors of all the members of the group, without regard to whether the members are subject to tax by the State. *Moorman Mfg. Co.*, 437 U.S. at 273. *See Barclays Bank*, 512 at 311-12 n. 10; *Shell Oil Co.*, 488 U.S. at 30-31; *Container Corp.*, 463 U.S. at 165; *Exxon Corp.*, 447 U.S. at 219; *Mobil Oil Corp.*, 445 U.S. at 436; *Northwestern States Portland Cement Co.*, 358 U.S. at 460. *See generally Butler Bros.*, 315 U.S. 501; *Hans Rees' Sons*, 283 U.S. 123; *Underwood Typewriter Co.*, 254 U.S. 113. The decision of the California Court of Appeal in this case is fully consistent with these decisions.

By asserting that California's apportionment method results in the "shifting of income" from a nontaxable corporation to taxable corporations, Deluxe necessarily is segregating the income of its unitary business enterprise into the separate income of each of the individual member corporations. This segregation can only be accomplished through separate accounting, which this Court has held "is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Container Corp*, 463 U.S. at 164-165. Thus, Deluxe's argument disregards the undisputed fact that each of its unitary members, whether taxable or nontaxable in the State, constitutes an integrated part of a single unitary enterprise.

The premise of Deluxe's argument is fundamentally at odds with the underlying theory of unitary business formula apportionment as reflected in California's system of combined reporting: the separate identity of the individual members of the unitary group is disregarded for

the purpose of determining the appropriate amount of the unitary group's combined income to apportion to the taxing State. *See Mobil Oil*, 445 U.S. at 439 ["the linchpin of apportionability in the field of state income taxation is the unitary business principle"]. This Court has never focused on the taxability of an individual corporation in determining whether its inclusion in a state's apportionable income base passes constitutional muster, and Deluxe has cited no authority in support of this proposition. Rather, this Court has held that the tie between a State and a nondomiciliary corporation that conducts part of a unitary business in the State is sufficiently established by the activities of the unitary enterprise in the State to allow that State to include the nondomiciliary corporation in the apportionable income base of the unitary enterprise consistent with the commerce clause. *Id.* Thus, the attribution of Current and Colwell's "sales and transactions actually occurring in California to California . . . reasonably recognizes the contribution of the state in producing the income of the unitary group." See *Citicorp, supra*, 83 Cal.App.4th at p. 1426.

California's apportionment method neither "shifts" nor "assigns" anything from one corporation to another or from one State to another. It merely apportions to the State a portion of the Deluxe unitary group's business income which reasonably approximates the level of business conducted by the unitary group in the State. Income attributable to California sources, which is the measure of a corporation's tax liability under California statutes, is then assigned to the member or members of the unitary business taxable in the State.

Deluxe is undisputedly engaged in a unitary business. Because its business is not truly separate and distinct from the other operations of the unitary group in California, its income may not be segregated clearly and accurately from those California operations. Thus, as the California Court of Appeal properly concluded, Current and Colwell's sales to California customers, regardless of the taxable or nontaxable status of the individual members of the unitary group that carry them out, may be appropriately considered in determining the income of the unitary group that is attributable to California sources.

CONCLUSION

For all of the foregoing reasons, the petition for writ of certiorari should be denied.

Dated: December 6, 2001

Respectfully submitted,

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APPENDIX A

RELEVANT CALIFORNIA STATUTES

Cal. Rev. & Tax Code § 23151 (1988)

23151. Imposition and rate of tax

(a) With the exception of financial corporations, every corporation doing business within the limits of this state and not expressly exempted from taxation by the provisions of the Constitution of this state or by this part, shall annually pay to the state, for the privilege of exercising its corporate franchises within this state, a tax according to or measured by its net income, to be computed at the rate of 7.6 percent upon the basis of its net income for the next preceding income year. In any event, each such corporation shall pay annually to the state, for the said privilege, a minimum tax determined in accordance with Section 23153.

(b) For calendar or fiscal years ending after June 30, 1973, the rate of tax shall be 9 percent instead of 7.6 percent as provided by subdivision (a).

(c) For calendar or fiscal years ending in 1980, the rate of tax shall be 9.6 percent.

(d) For calendar or fiscal years ending in 1981, the rate shall be determined as follows:

If the net cash collections under the Bank and Corporation Tax Law for 1979-80, as determined by the Controller, are:

Less than $2,950,000,000, the tax rate shall be 9.6 percent.

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If $2,950,000,000 or greater, but less that $3,025,000,000, the tax rate shall be 9.50 percent.

If $3,025,000,000 or greater, but less than $3,100,000,000, the tax rate shall be 9.45 percent.

If $3,100,000,000 or greater, the tax rate shall be 9.40 percent.

(e) For calendar or fiscal years ending in 1982 the rate shall be determined as follows:

If the net cash collections under the Bank and Corporation Tax Law for 1979-80 and 1980-81, as determined by the Controller, are:

Less than $6,000,000,000, the tax rate shall be 9.6 percent.

If $6,000,000,000 or greater, but less than $6,075,000,000, the tax rate shall be 9.50 percent.

If $6,075,000,000 or greater, but less than $6,150,000,000, the tax rate shall be 9.45 percent.

If $6,150,000,000 or greater, but less than $6,225,000,000, the tax rate shall be 9.40 percent.

If $6,225,000,000 or greater, the tax rate shall be 9.35 percent.

(f) For calendar or fiscal years ending in 1983 and thereafter the rate shall be determined as follows:

If the net cash collections under the Bank and Corporation Tax Law for 1979-80, 1980-81, and 1981-82, as determined by the Controller, are:

Less than $9,450,000,000, the tax rate shall be 9.6 percent.

If $9,450,000,000 or greater, but less than $9,252,000,000, the tax rate shall be 9.5 percent.

If $9,525,000,000 or greater, but less than $9,600,000,000, the tax rate shall be 9.45 percent.

If $9,600,000,000 or greater, but less than $9,675,000,000, the tax rate shall be 9.40 percent.

If $9,675,000,000 or greater, but less than $9,750,000,000, the tax rate shall be 9.35 percent.

If $9,750,000,000 or greater, the tax rate shall be 9.30 percent.

(g) For calendar or fiscal years ending in 1987 and thereafter, the tax rate shall be 9.3 percent.

Cal. Rev. & Tax Code § 24344 (1957)

§ 24344. (a) Except as limited by subsection (b), there shall be allowed as a deduction all interest paid or accrued during the income year on indebtedness of the taxpayer.

(b) If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the

provisions of Section 24402) not subject to allocation by formula.

Cal. Rev. & Tax Code § 25101 (1982)

§ 25101. Derivation from domestic and foreign sources; measure of tax; apportionment.

When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120). However, any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not the transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.

If the Franchise Tax Board reapportions net income upon its examination of any return, it shall, upon the written request of the taxpayer, disclose to it the basis upon which its reapportionment has been made.

Cal. Rev. & Tax Code § 25120 (1966)

§ 25120. Definitions

As used in Section 25120 to 25139, inclusive, which shall hereafter be referred to as "this act," unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and dispositions of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

Cal. Rev. & Tax Code § 25121 (1966)

§ 25121. Taxpayers liable

Any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its net income as provided in this act.

Cal. Rev. & Tax Code § 25122 (1966)

§ 25122. Tax liability in other state

For purposes of allocation and apportionment of income under this act, a taxpayer is taxable in another state if (a) in that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Cal. Rev. & Tax Code § 25123 (1966)

§ 25123. Allocation of nonbusiness income

Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Sections 25124 through 25127 of this act.

Cal. Rev. & Tax Code § 25124 (1966)

§ 25124. Net rents and royalties

(a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rent and royalties from tangible personal property are allocable to this state:

(1) If and to the extent that the property is utilized in this state, or

(2) In their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the income year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the income year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payor obtained possession.

Cal. Rev. & Tax Code § 25125 (1988)

§ 25125. Capital gains and losses

(a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if:

(1) The property had a situs in this state at the time of the sale, or

(2) The taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Except in the case of the sale of a partnership interest, capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's domicile is in this state.

(d) Gain or loss on the sale of a partnership interest is allocable to this state in the ratio of the original cost of partnership tangible property in the state to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than 50 percent of the value of partnership's assets consist of intangibles, gain or loss from the sale of the partnership interest is allocated to this state in accordance with the sale factor of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the partnership interest was sold.

Cal. Rev. & Tax Code § 25126 (1966)

§ 25126. Interest and dividends

Interest and dividends are allocable to the state if the taxpayer's commercial domicile is in this state.

Cal. Rev. & Tax Code § 25127 (1966)

§ 25127. Patent and copyright royalties

(a) Patent and copyright royalties are allocable to this state:

(1) If and to the extent that the patent or copyright is utilized by the payor in this state, or

(2) If and the extent that the patent or copyright is utilized by the payor in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states or utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

Cal. Rev. & Tax Code § 25128 (1966)

§ 25128. Allocation of business income

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

Cal. Rev. & Tax Code § 25129 (1966)

§ 25129. Property factor

The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year.

Cal. Rev. & Tax Code § 25130 (1966)

§ 25130 Valuation of property

Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any rental rate received by the taxpayer from subrentals.

Cal. Rev. & Tax Code § 25131 (1966)

§ 25131. Average value of property

The average value of property shall be determined by averaging the values at the beginning and ending of the income year but the Franchise Tax Board may require the averaging of monthly values during the income year if reasonably required to reflect properly the average value of the taxpayer's property.

Cal. Rev. & Tax Code § 25132 (1966)

§ 25132. Payroll factor

The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year.

Cal. Rev. & Tax Code § 25133 (1966)

§ 25133. Compensation paid in state

Compensation is paid in this state if:

(a) The individual's service is performed entirely within the state; or

(b) The individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) Some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

Cal. Rev. & Tax Code § 25134 (1966)

§ 25134. Sales factor

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year.

Cal. Rev. & Tax Code § 25135 (1966)

§ 25135. Situs of sales of tangible personal property

Sales of tangible personal property are in this state if:

(a) The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

Cal. Rev. & Tax Code § 25136 (1966)

§ 25136. Situs of sales of other than tangible personal property

Sales, other than sales of tangible personal property, are in this state if:

(a) The income producing activity is performed in this state; or

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(b) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Cal. Rev. & Tax Code § 25137 (1966)

§ 25137. Apportionment by franchise tax board

If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) Separate accounting;

(b) The exclusion of any one or more of the factors;

(c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Cal. Rev. & Tax Code § 25138 (1974)

§ 25138. Interpretation

This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it. Enactment of Article IV of the Multistate Tax Compact (as set forth in Section 38006 of the code)

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pertaining to the allocation and apportionment of income shall be construed as a reenactment of Sections 25120 to 25137, inclusive, without any inference that a change in interpretation is implied by such enactment.

Cal. Rev. & Tax Code § 25139 (1966)

§ 25139. Short title

Sections 25120 to 25139, inclusive, may be cited as the Uniform Division of Income for Tax Purposes Act.

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end